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IMPORTANT: This may be the most important Letter that I write all year, and yeah, I know it's only February. But this is what I'd like my subscribers to think about, to ponder over, to fix in their minds. The big picture, as I see it, can be expressed in two crucial words -- **GLOBAL DEFLATION**. How do I know? I see it in the stock market's poor breadth. Last week the advance-decline ratio broke below its December low and continued down. How come? The **majority** of stocks are going down because their earnings picture is deteriorating. They have **little or no pricing power**, but what they do have is **competition** -- plenty of vicious domestic and foreign competition.

As for the stock market, the market looks thin on the rallies. The rallies have been led by a handful of big-cap stocks and ".com" net stocks, but upside breadth is very poor. On the downside, breadth is broad and stocks decline across the board (even though the usual handful of big-cap or net stocks serve to cover up the poor action).

Turn to the A-D ratio chart on page 2. This chart has been telling us a story ever since early-April. It's a story of **deterioration**. Two other indicators add to the story. Both have to do with **prices and deflation**. Last week **the CRB Bridge Commodity Index** broke to a 21-year low. And last week still finds **gold** within shooting distance of a multi-year low. What is this telling us? I believe these two inflation/deflation sensitive items are discounting what we can look forward to -- continuing over-capacity and **GLOBAL DEFLATION**.

Global deflation is appearing at a very unfortunate time. It's appearing at a time when savings in the US are negative and when any so-called "savings" are in stocks or in the capital gains of those stocks. But money in the bank or in treasury bills or bonds are real savings. Paper profits that today are called "savings" (capital gains) can disappear in a few months of concentrated bear market action.

It's been three generations since real deflation has been seen in the US. Sure, economists talk about dis-inflation, which is simply a decline in the inflation rate. But I'm talking about **true deflation -- prices of things going down.** Sure business has had problems with pricing power. Sure, stores and manufacturers have been unable to raise their prices. But I'm talking about stores and manufacturers and retailers **lowering** their prices in an effort to attract buyers. And I'm talking about a public that is frightened, a public that doesn't want to buy, a public that suddenly decides that it needs to save.

If I'm correct, if we are heading into net deflation, it's going to come as a shock to Americans who have never had any experience with deflation. At first they won't believe it. But if the bear market moves into a higher gear, they will start to believe it. And here's the tough part -- **deflation is hell on debt**. Americans are loaded with debt and low on savings, so I'll repeat it -- deflation is hell on debt. What you owe stands, but what you earn declines during a deflation. That's what I believe we could face in the period ahead. And that's the advance warning I'm providing for my subscribers. Please, keep it in mind.

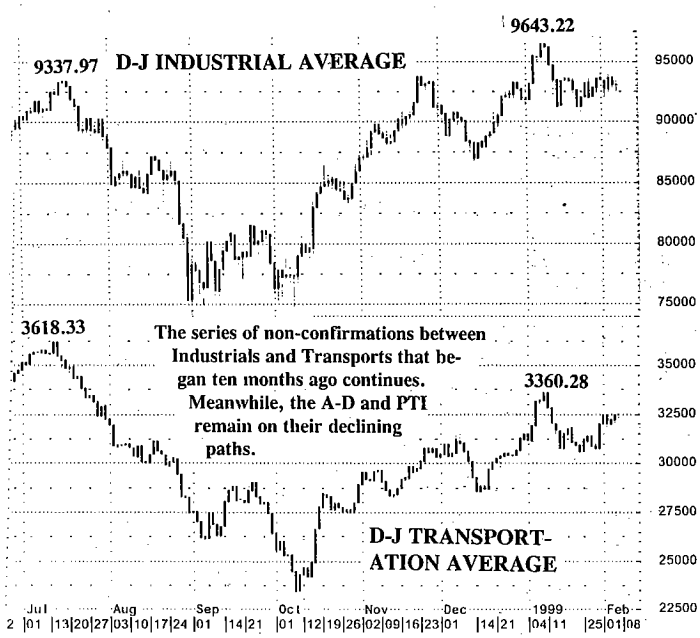
Jan. 29 DJIA 9358.83; PTI 5363; A-D Ratio +4.52
Feb. 5 DJIA 9304.24; PTI 5346; A-D Ratio +3.92
Dow Yield: 1.65%; Dow Price/Earnings: 23.8
Dow 144-day MA: 8693; Dow 34-day MA: 9166
Dow Times Book Value: 5.83; PTI 89-day MA: 5337
Percentage of Undervalued Blue-chips: 4%
Gold 34-day MA: 290

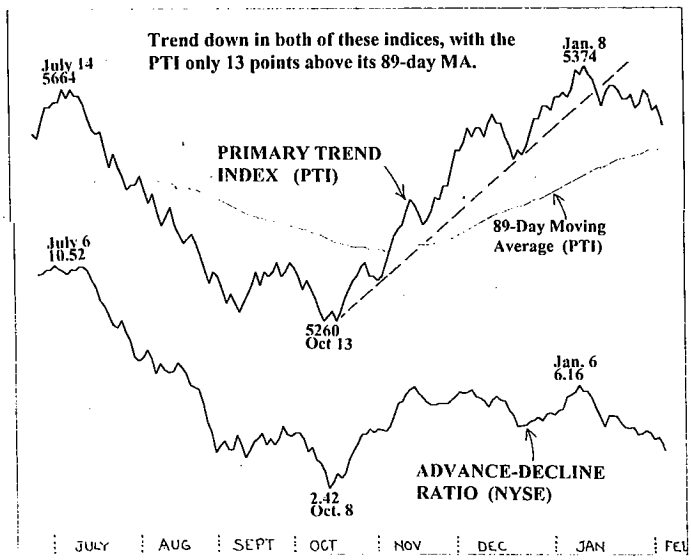
THE TECHNICAL PICTURE: On April 3, 1998, the advance-decline ratio topped out at 13.00. Two weeks later, on April 16, the D-J Transportation Average topped out at 3686.02. On April 21 the broad Value Line Composite of 1617 stocks (geometric) topped out at 508.39. On October 9 the D-J Utility Average topped out at 320.51. On January 8 the Dow hit its high of 9643.22. On the same day, January 8, the S&P 500 hit its high of 1275.09. And again, on January 8, the PTI hit its high of 5374.

Important: Any time a major average or indicator breaks below its December low in January, it constitutes a major negative for the entire market. On January 22 the **A-D ratio** broke below its December low. On February 1 the **D-J Utility Average** (a bellwether Average) broke below its December low.

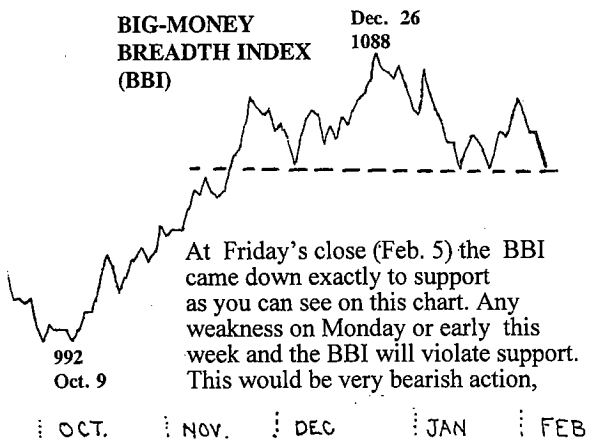
Conclusion: One by one the important averages and indices are topping out. One by one they're breaking below their December lows. It's been a long, tedious, deceptive topping process for the market, and it's still going on (I warned all last year that this market would not go down easily, not with the Fed fighting the bear forces "tooth and nail").

But the long series of non-confirmations and divergences continues. As this is written, the D-J Transportation Average is still more than 480 points below its April 16 record high. The A-D ratio has fared far worse. After declining to 2.42 on October 8, the A-D ratio rallied weakly (see page 2 chart). As this is written, the A-D ratio has recovered only 14% (!) of its April-to-October losses, a shockingly poor performance.


9643.22
9337.97
D-J INDUSTRIAL AVERAGE
95000
90000
85000
80000
75000
3618.33
The series of non-confirmations between Industrials and Transports that began ten months ago continues. Meanwhile, the A-D and PTI remain on their declining paths.
3360.28
35000
32500
30000
27500
25000
D-J TRANSPORTATION AVERAGE
22500
Jul Aug Sep Oct Nov Dec 1999 Feb
2 01 13 20 27 03 10 17 24 01 14 21 01 12 19 26 02 09 16 23 01 14 21 04 11 25 01 08



I show below my Big-Money Breadth Index (BBI). This is an advance-decline of the 10 biggest-cap stocks in the S&P. On the theory that "big money" tends to lead the market, I believe that the BBI is a valuable tool in tracing important accumulation and distribution and the direction of big money. Note that the BBI topped out on December 26, well before the S&P and Nasdaq. Note also that it has formed an ominous head-and-shoulders top. When the BBI breaks support, the market should be under severe pressure.


BIG-MONEY BREADTH INDEX (BBI)
Dec. 26 1088
At Friday's close (Feb. 5) the BBI came down exactly to support as you can see on this chart. Any weakness on Monday or early this week and the BBI will violate support. This would be very bearish action,
992 Oct. 9
OCT.
NOV.
DEC
JAN
FEB

That's the disjointed, bearish technical picture. **According to Dow Theory a primary bear market remains in force.** Despite the January 8 new highs in the big-cap stock averages, the stock market is reacting to **something in the background** that it doesn't like. That "something" is the reason why, as this is written, only 35% of all NYSE stocks are above their 200-day moving averages.

PUMPING AWAY DEFLATION? What could be holding the majority of stocks back? Here are a few of my thoughts: **(1)** It could well be that the stock market has simply **discounted the very best that lies ahead.** When the best is discounted by the market, there's nowhere to go but -- down. Personally, I believe that is what has happened. I think at today's valuations, the market has discounted the best economically, socially and politically that lies ahead. **(2)** The stock market is **discounting global deflation.** It could be as simple and as ominous as that.

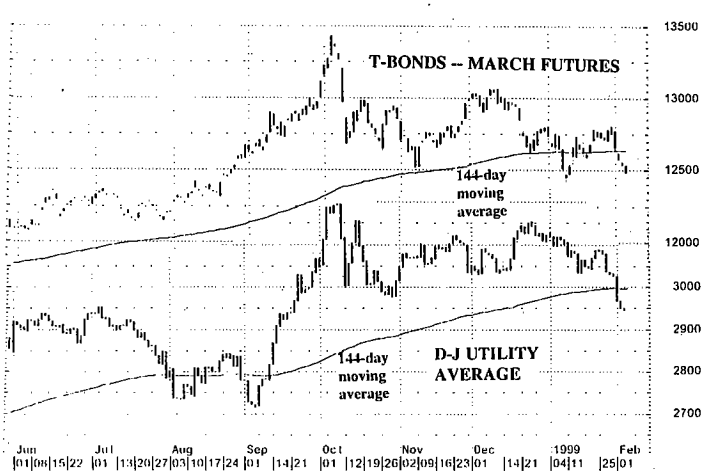
OK, those are a few bear market arguments, but c'mon, the bear signal was given back on August 4, so what's been holding the market up since then? I think it can be explained with one word - **liquidity. It's obvious to me that Greenspan is worried about world deflation.** Greenspan sees the world slump, the collapsing commodity indices. He sees gold and all the metals scrapping their lows, he sees the still-wide (bearish) spread between Treasury bond yields and Baa bond yields -- and he thinks, "We've got to keep the money supply surging -- if we don't, the world economy will sink into depression, and ahem, worse, so will the US stock market and the US economy." Result: The Fed is flooding the US and the world with a veritable sea of dollars. The Adjusted Monetary Base is exploding. The money supply is going through the roof. But question: Can a torrent of dollars solve the problem of world over-capacity? Hardly. And ironically, what the booming US money supply is doing is probably financing additional global capacity.

As far as the US is concerned, the torrent of money has to go somewhere. And it is going somewhere -- basically into the stock market, housing and general consumer spending. (Have you noted the crowds in America's most expensive restaurants?) Furthermore, the ocean of money has generated a gambling atmosphere in America. You can see it in the proliferation of casinos that are springing up everywhere. And you can see it on the stock exchanges as P/E multiples reach absurd levels, and as the public runs ".com" securities to heights that has old-timers shaking their heads in a mixture of awe and anxiety.

WHERE, WHAT? So question -- where should we be looking for indications of things to come? Aside from the obvious places such as the averages, I believe **the key lies in the action of the A-D ratio (breadth) and the PTI** (refer to the page 2 chart). The A-D ratio has been relentless in telling us that the market advance from the October low has been one of the narrowest in recent history. The fact is that breadth has been deteriorating ever since April 3. This year (1999) despite new highs in the Dow, the S&P and the Nasdaq, the A-D is actually down, and down decisively.

As for the **PTI,** it hit its high of 5374 over a month ago on January 8 -- since then it's been declining. On February 5 the PTI broke to its lowest level since December 22. Interestingly, in declining, the PTI has refused to confirm the rally and new mid-February highs in the S&P and the Nasdaq (the Dow, however, failed to make a new high). Note on the chart that the PTI has **broken below its rising trendline,** and that all its recent action since has been below the trendline. True, the PTI is still holding above its 89-day moving average, but the fact that it has been in a declining trend since January 8 is a definite negative for the market.

BONDS, UTILITIES: Bonds and utilities have been heading down and are looking quite bearish. I've done many studies of the **joint action** of these two. When bonds and utilities head up together, such action constitutes a very bullish force on the market. Conversely, when these two head down together they exert a bearish force on the market. They are now, as you can



see on the chart, heading down. Why the bearish action? My guess -- these two are very sensitive to forthcoming interest rates. With the Fed keeping the money supply spigots wide open, it's normal to expect interest rates to rise.

I want to add one item -- **in a bear market values deteriorate through the passage of time.** According to Dow Theory, the bear market started on April 16. That was the last day when both Averages, Industrials and Transports, recorded highs **together.** Ten months have elapsed since the bear market started. That means that there has been 10 months of subtle deterioration in values. As I see it, the longer the bear market forces are held back, delayed -- the more dangerous the situation becomes. In the end, the bear will have his way. And it will not be pretty.

The Flow: If we view the world economy as one massive flow of funds, what can we say about the flood of dollars that are being generated in the US? One answer could be that the dollar flood is being **cancelled out by the contraction in the economies of much of the rest of the world.** Consider the following: Japan and all of Asia remain in recession. G-7 (European) production is slowing. Germany, the "locomotive" of Europe, is showing zero growth as are France and Britain. Eastern Europe is in recession. Brazil, following its devaluation, is reeling, and all of Latin America is on the edge of recession. China is facing rising unemployment and is now in the position of having to deny that it will devalue the yuan. Russia has collapsed. All of this adds up to one thing -- we're dealing with a **global slump.**

European Economies Worsen Despite a Unified Currency

By EDMUND L. ANDREWS

FRANKFURT, Jan. 14 — Two weeks after 11 countries successfully began using a single currency, the euro, a raft of recent evidence indicates that their economies are stalling faster than experts had expected a few months ago.

At least in public, though, central bankers continue to discourage speculation about easing of monetary policy. "Unemployment in the euro area is largely structural in origin," the president of the central bank, Wim Duisenberg, said in a speech today in Amsterdam. "Implementing an inflationary monetary policy will not

currency's introduction.

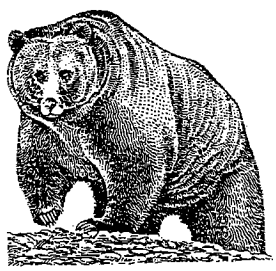
experts by surprise, the German Government reported on Tuesday that industrial production dropped 2.3 percent in November. That was much steeper than expected, and it suggested that the slowdown in other parts of the world may have stalled investment in German factories and equipment.

tive month as a result of gloomy expectations.

Similarly, German construction companies predicted today that they would have no growth at all this year and would eliminate about 50,000 jobs.

In the Netherlands, one of Europe's star economic performers the

INVESTMENT POSITION: The bear remains in the box. But I want to confess, so here's my side of the story. It's the one I grew up with. A child of hard values, a child of the Great Depression, I grew up conservative with a built-in dread of loss. I go through the *Barron's* statistics, and I note that the yield on the S&P 500 has now sunk to 1.32%. What this means is that any kind of total return now **depends on capital gains.** In other words, the stocks you buy **must go up** -- they must go up or else you're receiving almost no return on your money.



This puts you in the "hoping game." "Gee, I **hope** the stocks I bought go up, because if they don't, well, I'm sitting with dead wood. I'd be better off with T-bills or even bank deposit interest." At these prices, if the stocks you bought start declining and you're receiving no dividends to offset your losses, it gets kind of hair-raising. I've learned over the years that when I find myself hoping, I'm usually on the wrong side, the scary side of the stock market. When you buy great values, you don't hope, you just sit and patiently wait. Hoping is for speculators and gamblers -- I don't like hoping where the stock market is concerned.

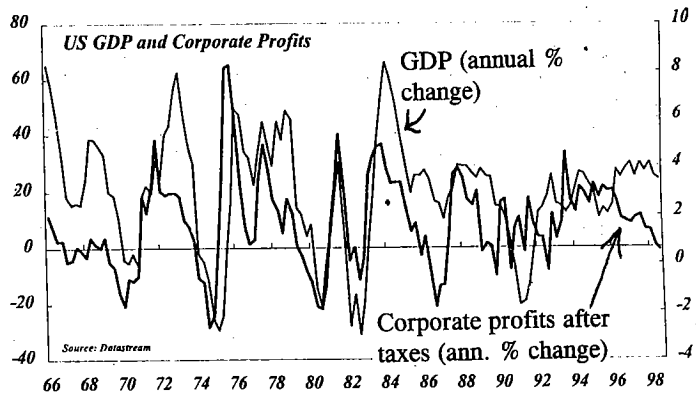
Now consider the following: the price/dividend ratio for the S&P 500 in January hit the unheard of high of **78.7**; compare that with the 1929 peak of 34.9, the 1973 peak of 37.7, the 1987 peak of 38.1. Meanwhile, the price/earnings ratio for the S&P on January 1 of this year was **33,** an all-time record by far for stocks near a cycle high.

Let me give you the reverse of all this. In the early '80s I bought stock in both Texaco and Exxon. Both of these high-grade stocks were then yielding a little better than 10%. The market at the time was very scary, but I thought, "OK, I'm getting 10% a year on these two. That's better than 30% compounded over three years. Let Texaco and Exxon go down another 30%, I'm still even and if they do drop 30% they'll be unbelievable bargains and I'll probably buy more." Of course, the stocks didn't decline. And they continued paying those fat dividends and later raised the dividends. That's what happens when you buy great values, good stocks with high, well-protected dividends. Exactly the opposite of conditions today.

This from Merrill Lynch's *Quantitative Viewpoint* (Jan. 19): "Our profit indicators continue to strongly suggest that corporate fundamentals are deteriorating. We expect the current 'profits recession' to continue through 1999." **Russell Comment:** What's happened, I believe, is that traders and speculators are playing the net stocks and the tech stocks where value is largely ignored and profits are not in the picture (in many cases there are losses). Instead, they're playing what we call "momentum." That's not investing, but as any Generation X-er will inform you, "What law says that you have to invest?"

With the PTI and the A-D declining, stay with T-bills and short T-notes. The time for intelligent, relatively safe buying just isn't here. It lies at the bottom of this bear market, and as I see it, the bear is just emerging from his lair.

NOTES & QUOTES: Here's a really interesting and highly significant chart [courtesy Pyford International, PLC -- (212)752-3650]. What this chart shows is that Gross Domestic Product (annual percentage change) tends to **follow the trend of corporate profits.** On a year-to-year basis US corporate profits have now turned negative. If history follows, GDP will soon be turning down. Remember, two quarters of declining GDP = recession. Therefore, based on this chart you have to ask yourself this question -- could the US be in recession before this year is out? The answer, as I see it, is, "Could be."



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This from the January 27 *London Financial Times: "The Federal Reserve has allowed monetary growth to accelerate since 1996 rather than slow. Mr. Greenspan barks; he does not bite . . . when money grows more quickly than the willingness of people to hold cash, the excess will be spent. The first object of additional spending is likely to be equities, property, foreign currencies and so forth . . . This seems to be a good description of the US today. The similarity with the Japan of the 1990s is striking. US growth of the broad money supply is comparable to Japan in its bubble days. Moreover, the ratio of the US stock market value to gross domestic product is nearly as high as Tokyo in early 1990, just before the crash . . . By now, the option of choking off the asset boom is, anyway, unavailable. It is simply too late. But how the US exits from its apparently unsustainable position will determine the verdict on Mr. Greenspan's time at the Fed."*

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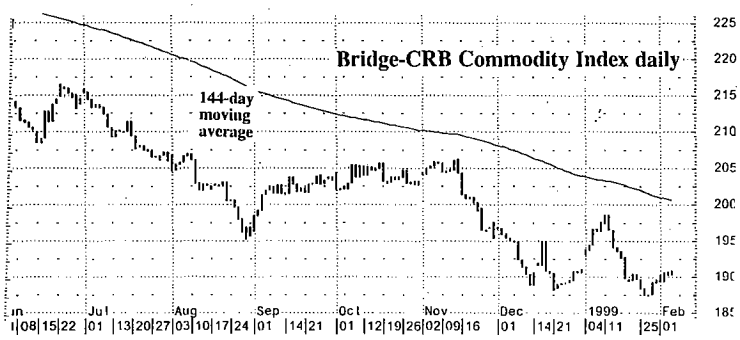
Last week the widely-followed Bridge-CRB Commodity Index broke to a 21-year low. The Index topped out on April 22, 1996, at a value of 261. Last week the Index was down to 187, a loss of 28.3%. Not only is this a large loss, but it's the persistence of the decline that's notable. The collapse of commodities, of course, is having its repercussions on US farms. Farmers in the US are in trouble due to declining crop prices; on top of that the price of farm land has been declining. Bill Gary [*Price Perceptions,* (800)231-0477], a commodity expert writes, "Economists view the devaluation as making Brazilian exports more competitive by about 30%. They also expect the devaluation to pressure currencies in other Latin American nations."



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This from David Dreman's column in the Feb. 8 *Forbes:* "The 4,600-stock Nasdaq Index, which is weighted for the capitalization of its companies, was up 40% for 1998. Twenty large-cap stocks including Microsoft, Cisco and Dell Computer, were responsible for 85% of the index's gain. Take them out, do an unweighted average of the other 4,580 stocks, and you have a loss of 4%."

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Item: Later this year China's Konka Group Co. plans to enter the emerging high-definition digital TV market with a set priced at around $3000. That's about **half** of what other manufacturers are charging.

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I've had quite a bit of personal experience with the Internet, and I want to give you my opinion. A few years ago I started with Prodigy, the hapless joint venture of Sears and IBM. I figured, Sears and IBM, this has to be good. Prodigy was a pain -- slow, and not that helpful. After a six months struggle, I gave up on Prodigy. AOL was next. In those "early days" I watched AOL via a phone line and the action was slow, very slow. Furthermore, it was maddening trying to get into the net from AOL.

Then about 18 months ago I ran directly into the net using Time Warner's fast "Road Runner" cable. Going right into the net, I soon lost interest in AOL and cancelled the service. Ah, the net -- I spent hours "discovering" the wonders of unlimited knowledge mainly using Yahoo as my portal. This "surfing the net" lasted about six months. I got bleary eyed looking up such subjects as poodles, Mercedes, hearts, Napoleon, health foods, market statistics, hot news.

Next stage -- I found that I was using Yahoo less and less. What happened was that I "discovered" about eight web sites that I wanted to hit every day, and that was about it. I really didn't need a portal, or if I did it was maybe once a week. I particularly liked CEOexpress (an incredible source of information), SmartMoney.com (it has an incredible map of the market) and Decision Point. So I put a total of about 10 web sites on my list of "favorites." The favorites are sites that I can bring up with a simple click of my mouse.

So that's it. And I wonder whether my experience is going to pretty much be the model for the average net user, once the user gets used to the novelty of the net. In the meantime, nobody really knows how to value the net stocks. Many of these stocks have capitalizations valued in the billions, but how are these values arrived at? Wall Street values these stocks in many exotic ways -- "eyeball counts," "traffic," "click-through rates," stuff like that. But the question is -- can any of these companies produce impressive profits? As I write Amazon's stock sells at 113. Amazon spends about $1.21 to generate every $1.00 of profit. Amazon now thinks in terms of reducing its losses, not making profits. Now Barnes & Noble advertises that is has twice as many books as Amazon and it will sell books at up to 40% discount.

The valuations of many of these net companies stagger the imagination. Some interesting comparisons, based on recent prices. E-trade's market value -- $5 billion vs. $25 billion for giant Merrill Lynch. Infoseek's market value -- $2.2 billion vs. $3.4 billion for Dow Jones. Amazon's market value -- $22 billion vs. $2.7 billion for Barnes & Noble. AOL's value -- $67 billion vs. $25 billion for CBS. Ebay's value -- $10 billion vs. $2 billion for Sotheby's. Yahoo's value -- $31 billion vs. $16 billion for Sears. That's the way it goes in the biggest speculative bubble I've seen in 45 years of watching markets.

* *

Buried in the *WSJ* of a few weeks ago was this little article. I believe it's highly important. It confirms what I've been saying all along -- the **Internet is inherently hostile to profits.** The fear started when a company called atCost announced that it will sell its computer products at wholesale prices. But Buy.com was already offering books, music, videos and computer products at or near cost. On January 25 Buy.com published a full page ad in the *WSJ* and the *NY Times* displaying various price comparisons. Buy.com showed that they were cutting prices of various items in competition with Amazon.com, Reel.com, Gamedealer.com, Beyond.com and Compusa.com. I thought the ad was fascinating, particularly since it provided the public with a number of competitive web sites (hardly what Buy.com was aiming at). A few days later Barnes & Noble came out with an ad stating that they offered more titles than anyone else and at discounts up to 40%. Just a peek of things (competition) to come.

Analyst Warns of Price War As Internet Stocks Lose Ground

By Susan Pulliam
And Robert McGough
Staff Reporters of The Wall Street Journal

Should investors get ready for a cyber-space price war?

Internet stocks lost some of their buoy-quarter results tomorrow.

Fears of a price war began surfacing last week after OnSale announced Tuesday that it will launch a service called "at-Cost," which will offer a broad selection of computer products at the same prices it

On top of all this, some hedge funds say that they are even laying bets against such giant retailers as Wal-Mart, Costco and Nordstrom on the theory that the retail business is a "zero sum" game, and if the net retailers take 10% or 20% of the market, the traditional retailers will stand to lose the same 10% or 20%.

My own instinct is as follows: I think that besides providing vicious competition, the net is going to be a negative for real estate. Thousands and thousands of brick and mortar buildings that represent stores, banks, malls, libraries, etc., will simply not be needed. They will just become unnecessary corporate expenses and in time they will be abandoned.

* *

The new euro is already having its problems. Here's a chart of the euro (March futures) plotted against the dollar. On January 17 the euro dropped below support, sinking to its lowest level (against the dollar) since early September. What does this mean? I think the weak euro is a reflection of the fact that Europe is moving into recession. Nevertheless, a weak euro will mean that Europe will have an advantage in importing merchandise to the US.

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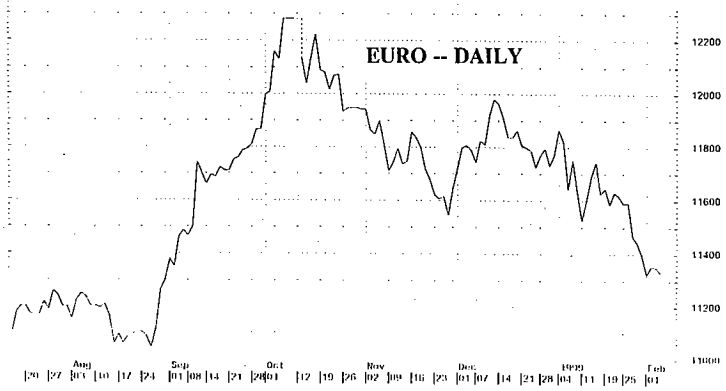
I find all the talk of the big budget surpluses both dishonest and aggravating. How can they talk about budget surpluses when the national debt is $5.6 trillion, and worse -- it keeps climbing? The really dishonest part of the "budget surplus" nonsense is



that the reason there is a "surplus" is that the Social Security receipts are taken in as part of the budget. Take away the SS receipts and the budget is still in the red. Disgusting, and the deceptions go on and on with gutless politicians afraid to tell the public what is really going on.

* *

Question: Can the US continue as the sole island of prosperity in a world that has sunk, or is sinking, into recession? So far, the answer is yes, but it's still early in the year. Here are a few headlines from the recent London *Financial Times* that are worth pondering. Incidentally, the *Times* provides a lot of news that you just don't receive in the US newspapers.

Japanese industrial output in sharpest fall for 23 years

By Alexandra Rusbaum in Tokyo

Shipments fell 8.4 per cent in 1998, compared with 1997, marking the first decline in Japan's electricity. The rise of 1.3 per cent in December was better than expected," that a survey of manufacturers found that production should rise 1 per cent in Jan- cent in

China softens its resolve not to devalue currency

Renminbi could weaken if balance of payments is hit, says bank chief

By James Kynge in Beijing

Dai Xianglong, China's central bank balance of payments of China, and there is a great increase in the cost of exports," he said. conditions were to develop this year. "We expect this year will be acutely difficult in terms of exports produc- year-on- 778,141 to the ssocia- ghly in xpecta- es were nt, and warm, r retail in. own in les and

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The Nutty '90s: Over the past five years the number of mutual funds has tripled. Since 1996 there have been 3,497 new funds, and they have pulled in $240 billion in assets . . . Microsoft, Intel, Cisco, MCI WorldCom and Dell now make up 30.8% of the Nasdaq composite. MSFT alone makes up 11.8% of the composite.

* *

I grew up in NYC (Manhattan, West Side and East Side) during the '30s, '40s and '50s when the city was livable. I left NYC in 1961 when the city started to become unlivable. But let's face it, NYC is where it's happening. Sure, California has the weather, the space, the Getty Museum, San Francisco, what's left of Hollywood, the Huntington, and a few other items. But NYC has MOMA, the Metropolitan, the Natural History Museum, the NYSE, the NY Botanical Gardens, the nation's (by far) best restaurants, the nation's best newspapers, the biggest crowds, Donald Trump, Broadway, Madison Avenue, Fifth Avenue, the theatre, Rockefeller Center, the St. Regis (my favorite hotel but no bargain), and on and on. At any rate, I don't want to live in NYC, but I do like the "feel." If you want the feel and atmosphere and craziness and crassness of the big city, subscribe to the *New York Observer*. The *Observer* makes fun of everything and everybody; it is very, very NY -- wit, irony, sex, gossip, excellent writing, good reviews, lots of irreverence. Comes out weekly all for $27 bucks a year, call (212)755-2400 (by the way, I make not a cent on anything recommended here).

* *

Talk about good times, Mercedes-Chrysler will be coming out with their Maybach, an "ultimate" in high-tech limo luxury -- and slated for a price of over $200,000. BMW will compete with its high-priced Rolls Royce and Volkswagen will take on both with its gorgeous Bentley. A Bentley showroom is located about half a mile north of my house. It's a great place for kicking tires, admiring paint -- and drooling.

* *

Are people still getting married? Yes, but a lot more couples are living in "unmarried-couple households," as the Census Bureau puts it. The unmarried couples have increased eightfold since 1970. Ponder these figures -- in 1970, 523,000 people lived as unmarried couples. In 1998, 4.2 million people lived as unmarried couples. In 1998, 56% of US adults, some 111 million people, were married and living with their spouses. Incredibly, that's 12% fewer than 20 years ago. **Russell Comment:** That would seem to suggest a drop in US morality. Which tells me a lot about the public's attitude toward the President. Lucky Clinton.

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Post-mortum on Clinton's State of the Union Speech (from Evans & Novak column): *"Clinton proposed 54 new government programs or expansions of existing programs in his speech, but kept his rhetoric so politically moderate that Republicans will be hard-pressed to resist them."* **Russell Comment:** Very few of this parade of new or expanded programs will ever pass Congress, and as usual, Clinton will push for very few of them. The whole exercise was simply Clinton's effort to show that he's really working very hard for you and I, "the people who hired him."

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The idea of drug legalization is still scorned by politicians and most Americans. As a result, tens of billions of dollars are being spent annually on the drug war. But the "war on drugs" has been lost, it was lost years ago. Listen to this from my old school friend, Don Morris of *Trident Syndicate* (PO Box 19909, Houston, TX 77224): "California's prison system is the largest in the industrialized world (with the number of drug offenders more than twice the total of all inmates in 1978) -- the California system is 40% larger than the Federal Prison Bureau, and holds more inmates than France, Great Britain, Germany, Japan, Singapore and the Netherlands combined. Simply to stay at the current *double* capacity, California must open a new prison annually for the foreseeable future . . . In America as a whole, there are 1.8 million behind bars -- 100,000 in federal custody, 1.1 million in state custody and 600,000 in local jails, a half million more than in Communist China . . . Half of all American inmates are black; one of every 14 blacks is in prison or jail." **Russell Comment:** Insanity.

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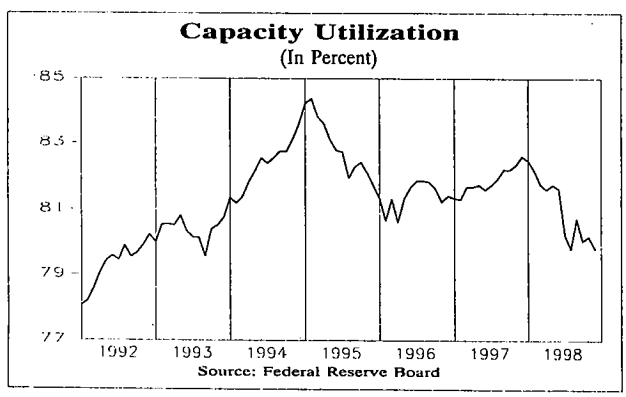
This is interesting: Business is booming in the US, but the boom is not in manufacturing, which I guess you can call America's "old" type of business. The new business is evidently information. This is *Value Line's* chart of **US factory utilization.** Utilization is now below 80%, meaning there's a lot of factory capacity that is not being used. But watch out -- if utilization continues to drop, it will be an indication of recession.



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Where is the most expensive residential real estate in the US? It seems that San Francisco is the winner. Last year the highest median home price of $315,000 and the highest average home price of $356,000 were both in San Francisco. On the opposite

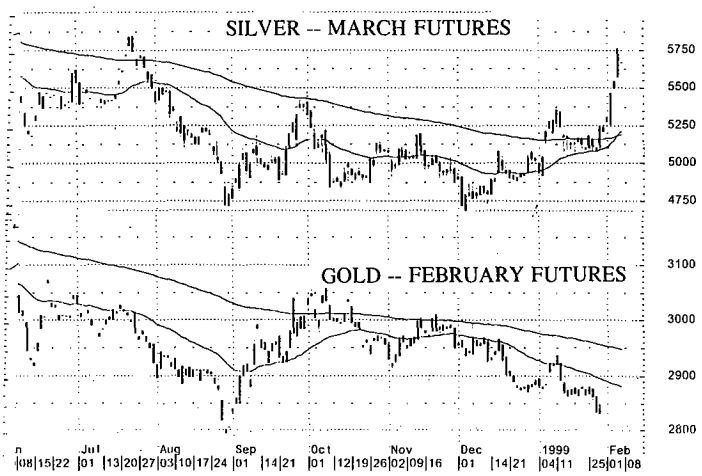
end, the lowest median and average price home prices, $107,100 and $119,000, were found in Orlando, FL. States with the largest increases in home prices: California -- up 8.5%; Mass. -- up 7.4%; Washington -- up 7%; New Hampshire -- up 6.8%, Mich. -- up 6%. Here in La Jolla, real estate brokers tell me that there is literally no inventory and that home prices are up an average of 26% over last year.

CHART BOOKS AND CHART PAGES 1998: Don't ask me why but in an industry that involves trillions of dollars, nobody else does this. What I'm talking about is chart books of the **D-J Averages** and the all-important **breadth index** (i.e. advance-decline ratio). I've been offering these two chart albums for decades, and I feel they're invaluable. Actually, I started these albums back in the '60s because I needed the data myself. The first volume is a **complete daily history** of the D-J Averages (all three Averages plus bonds and volume) going back to **1885**. Important economic and world events are notated on each page. The charts are packed in a big three-ring, hard-cover binder, one page for each year. The album is yours for $140; we pay the postage in the States. The second album covers the Dow and the extremely important A-D ratio (daily) going back to 1931. Comments regarding the action are included in many of the pages (one page for each year). The price is $100, we pay US postage. **For those who own the chart books**, the new 1998 pages are ready, and the price is $5 for the page of the Averages and $5 for the new A-D ratio page. Please send your money in now (outside the States there's an extra postage charge of $35 for each album). Write to Dow Theory Letters, PO Box 1759, La Jolla CA 92038.

WEBSITE: Finally -- our website is now up and running at www.dowtheoryletters.com. Current subscribers can sign up for web access to the (probably) daily PTI figures plus my (probably) daily after-market comments in the web sign-up area of the website (info should be on the web by 8PM EST). You can also change your address, renew your subscription and order chart books over the net. As this is a new service, please give us a couple of weeks to process the web sign-up requests and get back to you with your access information. For you old-timers who are not yet into PCs and who therefore won't be able to get this info -- c'mon, if I learned to use a computer at my age, you can too. It's not that hard and it's fun learning.

PRECIOUS METALS: The *WSJ* (Feb. 2) tells us that gold "is losing its luster as an asset." Can the *WSJ* be right? Nah, just because gold has been going down or doing nothing for 18 years doesn't mean it's finished. It probably means that the yellow metal is just "resting." Of course, that's the bullish view. The bearish view is that gold can't seem to climb above 300.

The charts tell an interesting story. Gold is still in the doldrums, well below both its 34-day moving average (288) and even further below its 144-day MA (295). Those are the two numbers that gold would have to better in order to look like "the turn is here."



Silver is another story: silver has surged. Note that silver's 34-day MA has now crossed above its 144-day MA (a buy signal). The silver contract is now testing its July high of 5.89, but so far the July high has stopped silver dead in its tracks.

Can silver run up and leave gold behind? Doesn't sound logical, but hey, it's been doing it. I'm not going to go into a long spiel in this Letter about the fundamentals. Sometimes it makes more sense just to do the charts and let the price action tell the story.

QUESTION: Russell, I know you believe we're in a bear market, but do you think this is "the big one?"

Answer: By the big one I assume you mean the grand-daddy, the one that's going to go down in history. Let me put it this way. Bear markets are tragedies, much as death is. But they happen. They happen at the end of every bull market -- and, I emphasize, at the end of **EVERY** bull market. So the question in my mind is not whether we're in a bear market, but whether this is the bear market that corrects the entire bull market of 1974 to 1998, a bull market that by my figuring has lasted an unprecedented 24 years.

The question is asked, "How can you call the whole rise from Dow 577 to Dow 9643, a rise of 9066 points, one single bull market?" My answer is that since 1974 we've never had what I call a true bear market correction. By that I mean a decline that corrected the preceding rise both in **duration and extent.** True we've had intervening, erratic periods such as 1978 to 1982, but never what I call a full-fledged bear market.

But let's be conservative. Let's say that the bull market started at Dow 776 in 1982. Certainly, we've never corrected the 1982-'98 rise, a rise of 8867 Dow points (during that period the Dow never closed below the low of a preceding year). I believe there's at least a fair chance that we're in for a bear market correction of that 16-year advance, an advance of 8867 points. If so, if that's what this bear market is all about, then it would not surprise me to see the Dow wipe out at least half of the 8867 point rise. If that happens, then we could easily see the Dow move down to around the 5200 area. However, most major bear markets have wiped out **over half** of the gains of the preceding bull market; therefore, it would not shock me to see the Dow drop below 5000 before the bear market is over.

The next question is what could drive the Dow down to 5000 or below? The answer is a deterioration in the economic, social and political fabric of the nation, plus extremely negative outside influences. How this could occur I can only speculate. I could write 10 fascinating scenarios about how it could happen, but that would put me in the category of a Hollywood screen writer. Let me put it this way -- the same craziness that drove the net stocks to seemingly crazy prices on the upside could work in reverse in a bear market and drive stocks in general to levels that today would seem beyond belief on the downside. I saw it happen in 1974, and I believe it could happen again.

As for the top that is developing in the stock market, it's huge and it's ominous. The top began in early April, and as this is written the top, in my opinion, is still in the development or distribution stage. If I had to put a figure or level on when the top was completed, I'd say that if and when the Dow drops first below 9100 and then below 8650 the top would be completed -- in which case, I would say that the bear would have finally emerged from his lair.

Over the years (45 to be exact), I've developed **three axioms** that I apply to bear markets, and they are worth thinking about. **(1)** In a bear market, whatever can go wrong -- will go wrong. **(2)** In a bear market, values deteriorate through the passage of time. **(3)** In a bear market, almost everyone loses, but the person who loses the least is the winner.

NEXT MAILING: Feb. 24, 1999